

Sociological, Psychological and Political Factors Behind the Informal Economy: Recommendations for Successful Development Policy

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Abstract

Informal economic activity is an inevitability that occurs around the world. There is a strong correlation between a region's level of development and the size of its informal economy. Although informal economies exist in both the developed and the developing world, they are more significant to the everyday lives of individuals in the Global South. This paper examines the ways in which sociological, psychological and political factors mediate the pervasiveness of the informal economy. Here, the argument is made that the objectives of development policy can more effectively meet the needs of the developing world if policy-makers work to reduce both the barriers to formal activity and the incentives to operate informally.

The vast majority of citizens in the developed world are employed in a formally recognized sector of the economy. Police officers, teachers, bureaucrats and employees from a multitude of other professions all sacrifice a portion of their income to the state via taxation. In exchange, governments maintain and develop infrastructure and provide a wide array of social assistance programs in an effort to maintain, if not exceed, the current standard of living that their citizens have come to expect. Although many individuals in the developed world (i.e. OECD member states) begrudgingly part with a portion of their salary, the governments of these countries have legitimate authority to extract a revenue from their citizens. There is an understanding that this money will, by and large, be used for the benefit of society as a whole.

This legitimacy has developed as a result of decades of respect and recognition for the basic factors which shape and influence citizens' perception of the role of the state. These factors can be placed into three categories: sociological, psychological and political. Sociological factors, such as a country's level of human development, opportunities for employment and ethnic tensions all work to embolden citizens with a sense that they can access the tools necessary to be successful in a competitive world. Citizens' perception of the role of government and its obligations towards the population create a 'psychological contract' between the individual and the state. This contract influences both the peoples' morale towards the government and the perceived legitimacy of tax authorities (Feld and Frey, 2005). Political factors – such as a state's (lack of) respect for good governance, perceived corruption and the strength of state institutions – are the most important of the three. They are strong indicators of the extent to which a government might allocate resources to improve social conditions and strengthen the resolve of the people. They also exert a strong influence over psychological factors, as they are ultimately the basis by which citizens judge their government.

In contrast to OECD-member countries, the overwhelming proportion of employment in the developing world stems from informal activities such as street vending, unlicensed taxi services, craftsmen or drug trafficking (Schneider and Bajada, 2005; Schneider, 2002). These are by no means a comprehensive list of informal economic activities, but they all highlight a fundamental aspect of the informal economy (IE) which sets it apart from formal activity: governments inability to raise revenue from informal employment. Although it may appear that workers in the IE may benefit by not donating a portion of their wages to tax authorities, informal employees in the developing world ultimately stand to lose. They are not covered by social security, and are therefore working at a higher risk relative to their formal counter-parts (Harris-White, 2010).

Although formal activity dominates the developed world, informal activity is not non-existent among OECD members. Black market activity in the United States during the 1970s was estimated to be equivalent to about 21.7 percent of GNP (Windebank, 1991). Ultimately there are two distinctions which should be made regarding informal activity in the developed and developing world. The nature of informal activity among OECD states tends to be centred around technical work or hobbies. For example, in Austria, 23 percent of all illicit work is related to carpentry and renovations, while car repairs and beauticians account for 19 and 14 percent, respectively (Schneider and Enste, 2002). Likewise, in Germany, 44 percent of illicit work can be accounted for by construction, renovations and repairs, while 9 percent stems from writing and translation services (Schneider and Enste, 2002). By and large, informal activity in the developed world stems from a desire or an interest to engage in such types of employment. Conversely, in the developing world, informal activity is the only way millions of individuals can collect an income.

The most distinctive difference between informal activity in the developed and developing world is the extent of its pervasiveness. Although still a significant source of economic activity among OECD states, the size and importance of the IE in the developed world is negligible compared to its importance among those in the developing world. There is a strong correlation between level of development and the size of a region's IE. Among OECD members, the IE amounts to about 12 percent of GNP (Schneider and Enste, 2002). Although still significant, it is hardly comparable to its importance in Africa, Latin America or Asia, where the IE accounts for 44, 39 and 35 percent of GNP, respectively (Schneider and Enste, 2002).

Informal economic activity is problematic for governments of the developing world because there is no way to extract revenue from informal employment. This paper will argue that the IE exerts a significant influence over the effectiveness of development policy. By reducing barriers to formalization and decreasing the incentives to operate informally, governments throughout the developing world will see significant increases in revenue through taxation. These revenues can then be used to further social and economic development. The reason the IE has played a diminished role among developed nations is because these nations have historically made a strong commitment to the three factors which are influential in a citizens' decisions to operate informally. Namely, the sociological, psychological and political factors mentioned above. We shall begin by outlining the scholarly literature regarding the IE. Next, we shall examine the impact that sociological, psychological and political factors have on the desire to engage in informal activity. Finally, we shall take a critical examination of IE-targeted development policies in the developing world. We will offer some suggestions as to how future

policymakers can benefit from reducing the barriers to formalization, by formulating development policies which address the sociological, psychological and political needs of their citizens.

Review of the literature

Although relatively insignificant in the developed world, the IE is a serious force in Africa, Latin America and Asia; equating to anywhere from 27 to 41 percent of a country's GDP (ILO, 2002). Throughout the developing world, being employed informally constitutes the norm and not the exception (Jütting and de Laiglesia, 2009a). It is well known that a country's IE can have tangible implications on the state, and activity within that sector has become a pervasive informal institution across the developing world (Dell'Anno, 2010).

Why do individuals work informally? For many, there is no choice; the formal economy simply cannot support them. Others, however, see some advantages to operating informally. Some are attracted by the idea that their income is entirely their own. In more socially-oriented countries, for example, Nicaragua during the 1980s, formal workers are required to pay for a bundle of social programs that often may be deemed unnecessary (Jütting and de Laiglesia, 2009a). Still, others view the IE as a way to sidestep government-imposed regulations and strict licensing requirements.

It should be noted that, from an individual's perspective, not all informal activity is necessarily negative. High levels of poverty have forced many professionals to take on additional jobs to supplement their income (King, 2001). Particularly in sub-Saharan Africa, but also throughout Latin America and Asia, public and private sector jobs either provide insufficient or irregular income. This forces professionals like police officers, university professors and bureaucrats, for example, to take on other jobs in addition to their primary commitment. In fact, both the governments of Tanzania and Kenya have endorsed formal workers supplementing their income with various on-the-side jobs (King, 2001). These additional jobs typically come from the informal sector. Not only does this become problematic for governments who are unable to extract revenue, these second and third jobs will undoubtedly begin to take their toll on the individual, affecting the productivity of their primary employment.

Although from an individual's perspective informal activity may not be problematic, it tends to constitute a major obstacle for development. The persistence of informal activity limits the effectiveness of employment as a means by which to achieve both social and economic development. The larger the size of the IE, the narrower the state's tax base; additionally, it prevents responsible governments from addressing social security concerns, and constitutes an inadequate use of human capital. Informal jobs tend to be less productive and less efficient (Jütting and de Laiglesia, 2009a). Indeed, formalization is beneficial to a state as it increases revenue through taxation, expands market opportunities and increases productivity (Jütting and de Laiglesia, 2009b), all of which increase the capacity for social and economic development.

Working in the informal sector does pose some significant drawbacks. Because states do not recognize such forms of employment, those who operate in this sector do so at a much higher risk than their formal counterparts. Being excluded from social security programs is a significant disincentive for informal activity. Many who are employed informally have unique social needs such as a high priority for housing, wage protection in the event of an illness, and the fact that

dependents are significantly disadvantaged in the event of the death of a main earner (Harris-White, 2010). Furthermore, those who operate informally are subjected to a substantial decrease in wages and are highly susceptible to abuse (Human Rights Watch, 2005). Migrant workers, for example, are particularly vulnerable to highly abusive labour policies such as under-paid wages (if they even receive a wage), long hours of work coupled with a lack of rest, and even violence at the hands of their employers (Human Rights Watch, 2005). Furthermore, some governments encourage domestic workers to migrate, as the remittances they generate are viewed as an important economic resource (Elias, 2010). Frequently, the work that migrant workers do is not even considered work at all. In Malaysia, migrant domestic workers are not considered to be 'workers' under existing labour legislation (Elias, 2010). As a result, they do not have access to the same kind of employment rights as other workers.

Those who operate informally lack representation in the policy making process (Tanaka, 2010). When taken together, the economic output of the IE across the developing world is enormous, equivalent to about 41 percent of the GDP in Latin America, Africa and Southeast Asia combined (Schneider, 2002). If the informal sector has such massive production power, how is it that those who are engaged in these outputs cannot exert an influence over policy formation? Tanaka (2010) argues that this lack of representation highlights a bias in the way political systems throughout the developing world formulate and implement policies. As we shall later examine, the failure to appropriately consider the informal economy in policy-making hinders the success of development in general. So, how have policymakers traditionally viewed the informal economy?

Unlike the early stages of urban population growth in Europe and North America, for many countries in the developing world urbanization occurred in the absence of an increase in formal manufacturing jobs (Potts, 2008). This naturally led citizens to seek an alternative source of income, and in the absence of formal employment opportunities many were forced to turn to informal means to make a living. At the time, the common policy position regarding the IE was that it is inherently backwards and inefficient (Potts, 2008). The consensus was that developing cities needed to rid themselves of these activities because, in order to achieve a higher standard of development, more sophisticated technologies and capital-intensive production was necessary. As the informal sector continued to grow, it then became viewed as a cushion against high levels of unemployment, allowing individuals to extract an income despite the lack of formal jobs. However, during the 1980s and 1990s, structural adjustment policies had a disruptive impact on the formal sector resulting in widespread factory closures and a reduction in once-secure government jobs (King, 2001). The overall effect was such that workers were being pushed out of formal employment and into the IE. Furthermore, the laissez-faire economic policies advocated by organizations like the International Monetary Fund and the World Bank prevented the kind of government-sponsored support necessary for small- and micro-enterprises in the informal sector to develop.

In the era of neoliberal economics, scholars remain divided on how to confront the IE. Three schools of thought have emerged regarding the relations between formal and informal sectors. The first group to substantially study the IE was the International Labour Office (ILO) in the 1970s (ILO, 1972). The ILO effectively founded the 'dualist' model of formality. Those who subscribe to the dualist school see the informal economy as a beneficial buffer, or safety net, in times of economic distress. Dualists perceive a fundamental distinction between formal and

informal economies; where informal activity is not a threat to the formal sector because it contributes positively to economic growth by creating employment out of unemployment. Informality, it is believed, will diminish with time as certain levels of economic growth and development are attained (ILO, 1972).

Clearly, there are some crucial flaws with the dualist school of thought. Most notably, the IE has not disappeared, but has actually expanded throughout the developing world over the years (Schneider and Enste, 2002). Furthermore, the dualist model does not account for the continued presence of informal activity within highly developed countries. In light of this, a second school was founded by Alejandro Portes and colleagues (see Portes and Schauffler, 1993 for review). The structuralist school, adheres to the belief that formal and informal institutions are inherently linked. Unlike the dualists, structuralists view informalization as a normal process that occurs as a result of development (Portes and Schauffler, 1993). For structuralists like Portes, formality can be achieved through an appropriate balance of fiscal and regulatory reform, coupled with a reduction in entry barriers and increases in micro-credit (Portes and Schauffler, 1993). Yet, what the structuralist school fails to acknowledge is that it is effectively the government of the day that has the capacity to implement such reforms. Thus, a third school has emerged – the legalist school. To some scholars (de Soto, 1989; Chen, 2006), government rules and regulations are responsible for stifling private enterprise, inadvertently erecting barriers to formalization.

Dualist, structuralist and legalist models of informal activity only account for a portion of the picture when, rather, one must step back in order to see the entire image. Although it is only correlational evidence, the failure of development policies and the expansion of informal activity in the late twentieth century, suggests that the IE merits a closer look in order to craft effective policies for social and economic development. We shall now turn our attention to an integrated model assessing the impact of the IE on development policy. As we shall see, a comprehensive model which takes into account sociological, psychological and political factors, and which recognizes the benefits and limitations to both formal and informal activity, is required for any development policy to truly be successful.

Sociological Factors

When examining the impact of sociological factors on the IE, an interesting trend emerges. There is a strong relation between a region's reliance on the IE and its level of human development. Consider sub-Saharan Africa. As a region, it has the lowest level of human development with an average HDI of 0.351 (UNDP, 2010). Its IE employs 54.2 percent of the region's workforce, and 24.6 percent of the region's entire population; it also equates 41 percent of the region's GNP (Schneider and Enste, 2002). In comparison, Southeast Asia has an average HDI of 0.653 (UNDP, 2010), while its IE employs 46.5 percent of the region's workforce and 19.5 percent of the total population; and equates only 26 percent of regional GNP (Schneider and Enste, 2002). What is particularly striking is that, despite its relatively high degree of entrenchment in the region's total economic output, the total value of the IE of all of Africa is only USD\$70 billion (Schneider, 2002). In comparison, Southeast Asia, with an IE that plays a much lower role in the lives of its citizens, has a value of USD\$531 billion (Schneider, 2002). These indicators highlight the importance of human development for the success of an informal economy. Evidently sociological factors influence the constructs of the IE, but how can development policy be crafted to acknowledge this?

A basic fact has emerged regarding the IE: women are more likely to be informally employed than men (Jahan, 2007: 165). Throughout the world, the IE tends to be segmented such that men are over-represented among 'top' positions in the sector while women remain over-represented at the bottom (Jahan, 2007: 163). These gender differences denote a common sociological trend regarding employment in general. By acknowledging this commonality between formal and informal employment, it would be beneficial for policymakers to focus on providing opportunities for women to advance their trade in both formal and informal sectors. One such possibility revolves around the conflict of balancing employment with their maternal roles. Supporting women in the informal sector with things such as child care would give them additional resources to ensure adequate care for their children, while also providing them with social security by allowing them to continue collecting an income.

A failure to recognize ethnic challenges is also a major setback to any development policy which attempts to facilitate a transition from informal to formal employment. As King (2001) remarks, this is predominantly an obstacle for Africans, as subcontracting opportunities in the region have a distinct racial dimension. A significant proportion of industrial ownership in Africa is managed and maintained by foreign multinationals. It has been common practice for executives to import their own labour to fill high-level positions, while subcontracting out more remedial positions to locals. As a result, there has been an absence of large-scale, African-owned formal sector enterprises. Such ethnically-motivated policies are creating a barrier for those who wish to become formal, by discouraging would-be micro-enterprises through both a lack of aspiring African entrepreneurs and a lack of high-level African representation inside chambers of commerce (King, 2001).

Psychological and Political Factors

Because psychological and political factors exert a reciprocal influence on one another, we shall consider them in tandem. Naturally, our subjective perception of an experience exerts an influence over our behaviour. Similarly, our perception of government influences our desires to engage in formal or informal activity. Recall that a government's legitimacy to extract taxes is enshrined in a psychological contract, where citizens accept their obligation to the state by forgoing a portion of their salary (Feld and Frey, 2005). If a government is perceived as moral, or that it is operating with the best interests of its citizens in mind, an individual is likely to accept the legitimacy of the state's institutions. As we have already mentioned, one incentive to operate informally is the desire to retain all of one's earnings from a state's collection agencies. If the state is perceived in a positive light, this incentive to operate informally is diminished. If, however, the state is viewed largely as corrupt and disengaged from the interests of its citizens, or if people believe that the government is collecting taxes in an inequitable manner, the psychological contract between citizen and government loses its legitimacy (Frey and Torgler, 2007).

Ultimately, the key to establishing legitimacy is through stable, democratic institutions. It is no secret that institutional weakness among developing countries is a major setback for democracy. A wide array of literature has focused on the influence of institutions on the IE (Dell'Anno, 2010; World Bank, 2002; Dreher and Schneider, 2010; Dreher et al., 2005; King, 2001; North, 1989). As Dell'Anno (2010) highlights, better institutions provide a better incentive for individuals to 'play by the rules' and operate formally. Whether or not governments are seen as corrupt is largely a consequence of whether their institutions are perceived as effective and

fair. Creating good institutions breeds a perception of good governance and as people's perceptions of government improve, the incentives to operate away from the reach of the state decrease. Thus, by strengthening institutions governments can facilitate formalization by increasing their perceived legitimacy. As the literature on economic psychology reveals, citizens are more likely to support the state through taxation if they perceive authorities as legitimate (Frey and Torgler, 2005). Although, whether directly or indirectly, all development policy intends to improve the image of the state in one way or another, policies tailored specifically towards increasing perceived legitimacy will go a long way to facilitate formalization and thus improve the capacity for social and economic development.

A common scenario among bureaucracies throughout the developing world is the notion of “eating from one's job” (King, 2001). Public sector officials often complain that their government does not pay them enough for their work. These negative perceptions influence the likelihood that officials will attempt to extract additional income from the government, most commonly through some form of bribery. A worker who is suppose to be collecting fines on behalf of the government might tell offenders that they will have to pay less if they pay him to turn a blind eye. Although to the official, his actions are justified because, in his view, the state is not providing appropriate compensation for his work, such bribery effectively reduces the revenues states have to pay salaries in the first place. Such actions facilitate corruption by producing a vicious cycle whereby more officials are required to supplement their income with bribery, while governments reduce or withhold salaries because they cannot bring in enough revenue; further increasing the incentive for officials to operate informally.

Policy Outcomes and Recommendations

In their recommendations to deal with informal employment, Jütting and de Laiglesia (2009b) put forth three recommendations for managing the IE. Naturally, governments must create more formal jobs. However, they must also provide incentives to formalize for those who voluntarily opt out of formal employment. Finally, they must provide social protection for those who remain in bad jobs, regardless of whether these jobs are formal or informal. Giving informal workers more rights, better access to services, and a voice in the policy-making process will facilitate development by not only reducing poverty, but also by bringing societies closer together (Jütting and de Laiglesia, 2009b).

Opportunities offered by the private sector, including the informal sector, have the greatest promise to train the next generation of entrepreneurs who are likely to provide employment and prosperity within the developing world (OECD, 2008). The informal sector provides a unique opportunity to improve human development. Targeting the IE as a means by which to provide informal education can be effective in improving the skill level within a society; especially one where education is put aside due to the intense level of poverty. We shall now turn our attention to various policies targeted towards the informal economy. In doing so, note how the desire to shut out the informal sector ultimately results in failure, and in some cases, the unintended effect of increasing poverty. The failure of these policies reflects neglect for the influence and importance of the IE on development policy, and a disregard for the sociological, psychological, and political factors which shape the rationale for acting informally.

There are many cases of how state interventions have strongly disadvantaged the livelihoods of the poor. There are equally as many cases illustrating how a government's

disregard for the pervasiveness of the IE results in major setbacks for development. In recent years, 'clean-up' campaigns have been implemented across the developing world to move vendors off the streets and into the formal market, in an effort to improve the urban image (Potts, 2008). In 2005, arguably the most controversial of these campaigns was underway in Zimbabwe (Potts, 2008; Bratton and Masunungure, 2006). Operation Murambatsvina was intended to "clear out the trash and restore order" to the streets of Zimbabwe's urban sprawls (Potts, 2008). The government crackdown was against all forms of informality and it is estimated that approximately 2.4 million people, or 20 percent of the country's population, was affected. The primary target of the program was informal housing. This was due to the notion that these illegal dwellings created an image of untidiness which negatively impacted the cities' images.

Over the course of the campaign, an estimated 92,460 homes were destroyed, leaving 570,000 people homeless (Potts, 2008). Although the program succeeded in disrupting Zimbabwe's IE, it had some powerful unintended side-effects. Principally, the Operation significantly diminished the credibility of the government, undermining key institutions like the police force. The policy was also unsuccessful in its aim to facilitate formalization as a means to develop the economy. In fact, in the five years after the Operation, Zimbabwe's economy shrunk by 40 percent; unemployment skyrocketed to a rate of at least 70 percent; and inflation reached triple-digits (Bratton and Masunungure, 2006). The irony is that, instead of moving citizens into the formal economy, Operation Murambatsvina forced many people to turn to the IE for employment as the country's economy spiralled further into chaos.

Zimbabwe's state involvement in the IE reflects a clear negligence for sociological factors like the need for adequate housing, as well as a lack of appreciation for psychological and political factors, such as the role played by institutions. State-intervention can only be a success if the government truly understands the delicate role that the IE plays in a country's social and economic development. Increasingly, governments in the developing world are recognizing that the IE economy is here to stay. Instead of trying to remove informality from society, policies are being developed which aim to be inclusive of those working in the informal sectors.

Thailand, for example, is taking steps to extend social security to informal workers. In an effort to boost the economy, the government is offering a new social insurance program which provides sick pay, life insurance and a pension to over 2 million workers (Montlake, 2011). Although the program is less comprehensive than typical welfare programs enjoyed by formal workers, it is affordable as workers only pay a minimum of USD\$3 per month. As an additional benefit, new Thai policies enable informal taxi and motorbike drivers, who apply for loans as a group, to receive preferential rates, promoting and facilitating cohesion among workers in the IE.

Concluding Remarks

Because the informal economy is here to stay, it is important for policy makers to realize that there is an inherent link between formality and informality. As Chen (2006) remarks, an appropriate policy response to the IE must promote equitable linkages between the two economies, while balancing the costs and benefits of working formally and informally. Over the course of this paper, we have argued that in order to be successful, development policy must integrate the IE. In doing so, policy makers must integrate sociological factors such as equal opportunities and human development with psychological and political factors, in an effort to support a positive perception of government through the strengthening of institutions.

Development policy will thus be more effective in meeting the needs of the overwhelming proportion of people who make their livelihoods outside of formally recognized employment.

Realistically, the IE can never truly be eliminated. The fact that informal activity still plays a significant role among OECD nations suggests that it is entirely possible for informal and formal sectors to coexist within a national economy. However, too much informal activity constitutes a major obstacle for development. Informal economic activity accounts for 41 percent of GNP within developing regions. This is a significant loss of revenue for governments. But rather than to try and combat the informal sector through regressive policies, like those seen in Zimbabwe, states should be reaching out to the informal sector through progressive development policies. This can be done by promoting inclusive social assistance, similar that found in Thailand, or by facilitating the move into formality by increasing equal opportunities for employment on both a gender, and an ethnic level.

To be most effective, however, development policy must target the root of the problem: the incentives to operate outside of the reach of the state. In order to do so they must tailor policies towards maintaining a legitimate psychological contract between citizen and government. It is only through strong and reliable institutions that the IE can be effectively managed. Effective formal institutions increase the drive to operate formally, therefore increasing state revenue through taxation. Appropriate tax regulations provide governments with a better opportunity to establish policies reflecting the social and economic needs of its citizens. Ultimately, the pervasiveness of the IE in the developing world has resulted from a lack of respect for what is truly driving informal activity, as well as for the potential influences the IE can exert over social and economic development. Developed countries have managed to ensure that formal activity constitutes the norm through decades of respect and recognition for the sociological, psychological, and political factors which influence the IE. To achieve the maximum benefit from development policy, policymakers in the developing world must do the same.

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